

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 7
September 1, 1994
Item No. 1 of 1

FINDING/RECOMMENDATION:

Georgia PSC auditors should be provided access to all income tax returns and related workpapers.

COMPANY RESPONSE:

This finding is based on the same misunderstanding of the Company consolidated tax return as is evidenced in finding No. 2. As stated in the response to that item, the Company is in full compliance with all the FCC's rules, Part 32 and the Internal Revenue Code. Georgia's tax liability is calculated on a stand-alone basis and the tax liabilities of the nonregulated affiliates are not relevant to that calculation.

In addition, this finding is totally without merit since the Company has: (1) provided a detailed reconciliation of the Southern Bell (SB) income tax return liability to the Georgia intrastate tax expense and (2) also has reconciled the SB tax return to the BellSouth Corporate (BSC) tax return. Over the course of the audit, Company personnel from the Tax and Comptrollers organizations have spent approximately 10 employee days with the auditors answering tax-related questions and providing reconciliations. Additional discussions with Company personnel occurred during follow-up sessions.

For reconciliation purposes, financial information for the SB nonregulated entities and other states was provided. Two detailed reconciliation packages dated September 15 and September 20, 1993, were developed and submitted to the auditors. These packages (over 30 pages) provided a detailed reconciliation of the 1991 SB tax return liability to the intrastate tax expense per the December 1991 surveillance report. Also, the packages included a detailed comparison (for both SB and Georgia) of the 1991 federal income tax expense to the 1991 tax return as filed.

Furthermore, a reconciliation of the SB tax return to the BSC tax return was provided during discussions with the auditors in September, 1993. Access to the individual returns of the nonregulated affiliates was not necessary as discussed above, since Georgia's federal income tax expense is based solely upon Georgia's state specific income.

This finding is wholly without merit. The recommendation that access to all tax returns and workpapers be provided is completely unnecessary for the reasons discussed above. Ample data was provided for the auditors to ascertain the complete compliance and appropriateness of all relevant tax calculations.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 8
September 1, 1994
Page 1 of 4

FINDING/RECOMMENDATION:

The Company should be chastised for adding MemoryCall² losses to the Surveillance Report without notifying the Commission and the Company's failure to file tariffs and supporting cost of service studies.

COMPANY RESPONSE:

The Company is in full compliance with all Commission orders regarding MemoryCall². Details concerning the report's specific findings are provided below.

FILING OF TARIFF

Southern Bell has not been ordered by the Commission to file a tariff covering the provision of MemoryCall². As this finding was originally cast, the auditors concluded that Southern Bell had failed to file a tariff in disregard of Commission orders in Docket No. 3896-U. The Company pointed out to the auditors that those orders (Docket No. 3896-U, March 5, 1991; April 2, 1991) were stayed by the Fulton County Superior Court on April 5, 1991. Southern Bell Tel. & Tel. Co. v. Georgia Public Service Comm'n, et al., Civil Action File No. D-86218.¹

The auditors have now shifted their analysis to Docket No. 4000-U (the correct docket), but continue to strain to reach the conclusion that the Company should have filed a tariff. The auditors state, "[i]t appears Southern Bell determined, on an informal basis, how it intended to interrupt and implement the various provisions of the order in Docket No. 4000-U." Report at III, p. 41. In fact, Southern Bell petitioned the F.C.C. to preempt the Commission's "freeze" on the provisions of MemoryCall², which the F.C.C. did. The F.C.C.'s preemption was upheld by the Eleventh Circuit Court of Appeal on September 22, 1993. However, one might construe the F.C.C.'s preemption order and subsequent court appeals, these actions were not informal. During the course of the litigation, and until this day, the Commission has abstained from further action regarding MemoryCall² and has never ordered the Company to file a tariff.

²MemoryCall is a Registered Trademark of BellSouth Telecommunications

¹NOTE: The Fulton County Superior Court action was eventually dismissed without prejudice because the orders referred to had been superseded by later orders of the Commission. Southern Bell Tel. & Tel. Co. v. Georgia Public Service Comm'n, et al., Dismissal of Petition for Review without Prejudice, Civil Action File No. D-86218, September 2, 1992.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 8
September 1, 1994
Page 2 of 4

COMPANY RESPONSE (Cont'd.):

The auditors have overlooked or ignored other important developments in Docket No. 4000-U since the May 21, 1991 order.² On July 26, 1991, the Georgia Association of Teleessaging Services ("GATS") filed a petition asking the Commission to clarify its earlier order. In pertinent part, GATS asked the Commission to clarify the Commission's intentions regarding tariffing of MemoryCall[®]. GATS urged the Commission to avoid any interpretation of the May 21 order that would involve a tariff to diminish the likelihood that the F.C.C. would preempt regulation of MemoryCall[®]. The issue of whether the Commission should ultimately require tariff filings was squarely raised before the Commission.

Provision of MemoryCall[®] has received intense scrutiny by the Commission and other parties to Docket No. 4000-U. During the course of the audit, the Company has made every effort to explain the record in the various MemoryCall[®] proceedings. In fact, in their report, the auditors include a portion of the transcript of a hearing before this Commission. The pertinent portion of the quote bears repeating here. In an open hearing, before all the Commissioners, the Staff, the CUC and other parties, the Company's witness stated:

But from the standpoint of the earnings report, since the Georgia Commission had ruled and that was the rule of the day, then the non-regulated -- previously non-regulated investment expenses for MemoryCall[®] were included in the intrastate results starting in June of 1991.

²NOTE: The auditors have likewise overlooked a protracted dispute which resulted in litigation regarding the Commission's and its Staff's ability to enter into a protective agreement. The detailed cost information sought by the Commission in its Order is confidential trade secret information entitled to protection under Georgia law. The Company and Staff eventually worked out an arrangement through which Staff reviewed the cost data. It was not filed because the Commission took that no mechanism exists which would have afforded the information protection while in the possession of the Commission. More recently, the Commission has initiated a rule-making, in response to an order of Fulton County Superior Court, to create such a mechanism. In any event, the Staff has had access to and has reviewed the cost data.

[®]MemoryCall is a Registered Trademark of BellSouth Telecommunications

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 8
September 1, 1994
Page 3 of 4

COMPANY RESPONSE (Cont'd.):

This statement was made before the Commission on February 19, 1992. If there was doubt before this point, which the Company would dispute, there was certainly no doubt after this point regarding the treatment of MemoryCall².³

Finally, two facts are noticeably absent from the finding which make it impossible to respond fully. First, there is no reference to the factual basis upon which the auditors conclude that the Commission is unaware that MemoryCall² is being treated as regulated for intrastate reporting purposes. In fact, the contrary appears to be the case. Second, the auditors failed to point to any rule or regulation of this Commission which would require the Company to notify the Commission that it is complying with the Commission's orders. The simple fact is that on May 21, 1991, the Commission entered an order stating its clear intention that MemoryCall² be regulated. The Commission went in to an elaborate discussion regarding its jurisdiction in the order. Immediately following the effective date of the Order, Southern Bell took an appeal from one portion of the order and implemented that portion which was final and from which no appeal was taken. No further action was contemplated, ordered or necessary.

MemoryCall² OPERATIONS

The basic assertion that MemoryCall² is losing money is predicated on a fully distributed cost methodology which drives significantly more costs to unregulated operations than is appropriate. Similarly, it is not possible to determine the "profitability" of a product based on its allocated and fully distributed cost, as was the case here.

Also, virtually all new products and services introduced in any business involve "up front" investment commitments and "start up" costs which begin before the product or service is offered for sale. It is not practical or feasible to expect that such costs can be fully recovered by sales revenues in the initial years. Typically, such costs are recovered over a number of

²MemoryCall is a Registered Trademark of BellSouth Telecommunications

³NOTE: Contrary to the auditors' report, this not the only reference in a record acknowledging that MemoryCall² was being treated as regulated for intrastate reporting purposes. There are others. However, this one was so obvious and so unambiguous that no others had been provided.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 8
September 1, 1994
Page 4 of 4

COMPANY RESPONSE (Cont'd.):

years. In other words, the cash flow in the early years of most products and services is negative due to this mismatch of costs and revenues. As additional units are sold over time, a crossover is realized and a net profit or contribution is generated over the life cycle of the product or service. This is especially the case with MemoryCall[®] since it is a capital intensive service.

The conditions also totally overlook the contribution from the tariffed service charges which MemoryCall[®] pays the regulated operations similar to any other Enhanced Service Provider. Also, the results do not include complementing network services (CNSs) such as "call forwarding busy line/don't answer" and Message Waiting Indicator (MWI) which are frequently used in conjunction with MemoryCall[®] mailboxes.

Beyond this, the Company would note that it was temporarily forced out of selling MemoryCall[®] for approximately 8 months by the Commission and precluded from providing the service in portions of Georgia other than the Atlanta area for over two years. Consequently, even if there were any merit in the auditors comments regarding "profit", MemoryCall[®] is still a new product whose marketing has been limited over the past few years, which clearly would affect its profitability. Furthermore, investment costs and other ongoing expenses for the service continued because the MemoryCall[®] network structure remained in place in anticipation of customer demand.

CONCLUSION

Southern Bell is in full and complete compliance with all rules, regulations and orders of this Commission regarding MemoryCall[®]. Furthermore, the assertion that MemoryCall[®] is losing money is inappropriately predicated on a fully distributed cost methodology, overlooks tariffed service charges and complementing network services and ignores the "start up" nature of MemoryCall[®].

[®]MemoryCall is Registered Trademark of BellSouth Telecommunications

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 9
September 1, 1994
Page 1 of 1

FINDING/RECOMMENDATION:

Southern Bell's construction program should be regularly audited.

COMPANY RESPONSE:

The auditors focused a great deal of attention on the MemoryCall[®] construction program. This inordinate scrutiny revealed only (1) a misclassification which existing controls identified and corrected on a real-time basis, (2) a minor misclassification of \$28,500 and (3) a one month timing difference associated with an input file in the Company's Cost Separation System (CSS). The above issues are all minor in nature, and do not require that the Company's "construction program ... be regularly audited".

With regard to the first issue, in November 1990, the Company did erroneously assign some MemoryCall[®] investment as regulated investment. However as noted in the report, this discrepancy was detected as part of the Company's normal review of the monthly CSS cost allocation activity in December 1990. An adjustment was made in December 1990 to move the investment from regulated to dedicated nonregulated. Therefore, there was NO cost allocation impact and the MemoryCall[®] investment was correctly reflected both in CSS and on the Georgia Surveillance Report.

Regarding the second issue, MemoryCall[®] right-to-use fees of \$28,500 in estimate M-1418 were originally booked incorrectly to capital instead of expense. However as noted in the report, an adjustment was made in May, 1993 to move the right-to-use fees from capital (Account 2212, 377C) to expense (Account 6212, 377M).

In regard to the last issue, the report notes that this simply was a timing difference due to a one month lag between the Company's Detailed Continuing Property Record (DCPR) and its Cost Separation System (CSS). The DCPR file is an input for identifying investment for CSS. Each month's DCPR file is processed by CSS the following month. Furthermore, each year the investment in CSS is synchronized with the DCPR investment after completion of an annual true-up of central office equipment. This ensures that all regulated and nonregulated investment is appropriately reflected in CSS.

[®]MemoryCall is a Registered Trademark of BellSouth Corp.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 10
September 1, 1994
Page 1 of 1

FINDING/RECOMMENDATION:

Right-To-Use fees should be directly assigned whenever possible.

COMPANY RESPONSE:

In January 1993, the Company independently developed the methodology and system changes which were necessary to revise the Cost Separation System (CSS) allocation process to directly assign software right-to-use fees to regulated or nonregulated whenever possible. This allows MemoryCall[®] software right-to-use fees to be directly assigned to nonregulated.

Prior to January 1993, a methodology did not exist for the Company to directly assign right-to-use fees between regulated and nonregulated operations. Prior to 1993, all software right-to-use fees in Account 6212 were considered common and were allocated based upon the related central office investment. The vast majority of right-to-use fees are entirely regulated but these too were included in the apportionment process.

Furthermore, the Company did consistently use the Cost Allocation Manual's (CAM) Account 6212 direct cost pool during the entire period of 1989-1993. This direct pool was initially established and used for Equal Access/Network Reconfiguration investment in June 1989. The pool was also subsequently used for leased to others investment (e.g., Shared Network Facilities Agreement) until January 1993. As stated above, methodology was developed and implemented in January 1993 to directly assign right-to-use fees.

[®]MemoryCall is a Registered Trademark of BellSouth Corp.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 11
September 1, 1994
Page 1 of 3

FINDING/RECOMMENDATION:

The Commission should investigate the implications of a 1990 switch price restructure and increase its audit scrutiny of BellSouth to ensure that basic business and residential ratepayers are protected against cross-subsidies.

COMPANY RESPONSE:

Apparently, the auditors have concluded that the expense decrease negotiated by the Company with AT&T was offset by increased capital expenditures. In addition, the auditors have reached the conclusion that AT&T's price restructure resulted in a shift from competitive services to noncompetitive services. These allegations are unfounded and in fact, the subject price restructure and associated contractual arrangements resulted in reductions in overall switch expenditures which is what the Company intended to achieve from the outset.

The auditors have repeatedly been provided proof refuting all of their allegations. Numerous meetings between the auditors and Company SMEs (including an Officer) were facilitated to address the auditors' "issues". Actual Firm Price Quotes, for both initial and growth switch projects (pre and post restructure) were also provided and explained in excruciating detail. These quotes, actual contracts, price lists, surrogate cost studies and other documentation have repeatedly demonstrated beyond a reasonable doubt that price restructure and associated contractual arrangements have resulted in an overall switch cost reduction, thereby benefiting the ratepayers of Georgia. Further, these efforts have also proved that AT&T's price restructure did not result in a shift of expense to capital.

First, contrary to the Auditors' inferences, AT&T's price restructure had no relationship to Southern Bell's 1990 switch award. Rather, each approved switch vendor was invited to reply to a Request for Quotation (RFQ) and both AT&T and Northern Telecom were awarded switches based on responses to this RFQ. Therefore any insinuation that the central offices awarded to AT&T were due to price restructure is unfounded.

Second, the insinuation that Southern Bell was involved in a deliberate shift of central office costs from expense to capital is unfounded. The analog line card was the only hardware (capital) item that increased in list price as a result of price restructure. As the auditors correctly noted, the line unit (a capital item) decreased in price. It should also be noted that the switch module (also a capital item) decreased in price. As previously stated, comparisons of pre and post price restructure jobs

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 11
September 1, 1994
Page 2 of 3

COMPANY RESPONSE (Cont'd.):

(initial and growth) clearly indicate that there was no shift from expense to capital, and in fact there was an overall reduction in both capital and expense costs.

Third, in regards to the auditors contention that there has been a shift from competitive (i.e., ESSX²) to noncompetitive residential and basic business services, the Company has repeatedly explained the following points:

- A. 70% of Georgia lines-in-service during the audit period were analog. Every analog line, whether it be a residence, basic business or an ESSX² line, must have access to a line unit. Since analog line cards are used with all classes of service (basic business, residence or ESSX²) any price increase associated with line cards would not benefit or act to the detriment of any particular customer group. In addition, contrary to the auditors' findings in footnote #38, the Company has provided the auditors evidence that the price of capitalized operating system software did not change as a result of the price restructure.
- B. The auditors were correct that BRCS I supported basic business and residence lines prior to Universal BRCS. Universal BRCS contains six additional features that were never included in BRCS I. Since each of these additional features (i.e.- cancel call waiting, call hold, automatic callback calling, call forwarding-busy line, call forwarding-don't answer-all calls, and distinctive ringing) has value and revenue potential, it is not feasible to make a simple comparison between the BRCS I and Universal BRCS feature packages. The only possible inference that can be derived is that Universal BRCS became more feature rich, and thereby potentially more valuable, at the expense of BRCS ESSX². (The six additional features contained in Universal BRCS were removed from the BRCS ESSX² feature package).
- C. Basic business and residence customers actually benefited from the regrouping of a greater number of non ESSX²-specific features which became available coincident with this restructure. These features allow SBT to market contribution-rich services to these customers which help offset the cost of basic service. It is also important to note that there has been no increase in basic business or residence service rates as a result of this restructure.

Fourth, as the auditors' have independently corroborated with AT&T, price restructure was implemented nationwide and was in no way unique to BellSouth. Obviously, the concerns expressed by one customer, albeit a

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 11
September 1, 1994
Page 3 of 3

COMPANY RESPONSE (Cont'd.):

major one, would not cause an overall nationwide change in AT&T's switch pricing. Therefore, the allegation that the restructure was specifically directed to concerns expressed to AT&T Network Systems by BellSouth is clearly unfounded.

AT&T is outraged by this allegation and sent an unsolicited letter to the PSC audit manager with a copy to all the Commissioners. An affidavit was attached to the letter signed by an AT&T employee involved in the restructure testifying in no uncertain terms that the restructure was a result of market research conducted by AT&T.

Fifth, these allegations were sufficiently important, and objectionable, to Southern Bell that the Company retained an unaffiliated third-party Consulting/Accounting firm to investigate this matter in detail and to provide an unbiased expert opinion. This firm's conclusions agree with the Company's position in this regard and find no merits in any of the auditors' allegations.

As a final note, even in the face of extensive analyses provided by the Company to the auditors, AT&T's independent challenge to the auditors' conclusions, and the analyses of a major accounting firm's independent review, the auditors continued down the wrong track. This displays most poignantly the auditors' lack of objectivity.

ESS is a registered trademark of AT&T
ESSX is a registered trademark of AT&T

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 12
September 1, 1994
Page 1 of 5

FINDING/RECOMMENDATION:

The inclusion of BellSouth Services' net income and equity in the Surveillance Report provided a subsidy for its nonregulated CPE products and masked the over-earnings on sales to the regulated operations.

COMPANY RESPONSE:

This finding indicates a failure on the part of the auditors to understand the relationships between SB and BSS and between SB and its customers. It also fails to recognize that moving the BSS dividend and investment above the line is a further protection to the ratepayer.

The auditors' confusion about the relationship between BSS and SB and the relationship between SB and its customers has led the auditors to make a number of erroneous conclusions. The auditors' statement that "Business CPE was an unprofitable line of business and never should have been added back to regulated operations" is based on confusing the two relationships. CPE was a nonregulated line of business at SB and was always treated as nonregulated on SB books. BSS was not in the CPE business and had no losses related to CPE.¹

The Company will address these issues by discussing the following points:

1. BSS/SB Relationships and SB/SB Customer Relationship,
2. BSS' billing methodology,
3. CPE Operations,
4. BSS Equity,
5. Handling of BSS Income and Investment for Ratemaking.

¹BSS did have a nonregulated subsidiary, BellSouth Products, (BSP) which marketed certain CPE products. However, as noted in the auditor's report, BSP results were not included in the BSS dividend and investment which were included in intrastate results.

COMPANY RESPONSE (Cont'd.):

BSS/SB RELATIONSHIP AND SB/SB CUSTOMER RELATIONSHIP

The auditor has confused the relationship between BSS and SB with the relationship between SB and its customers. A description of the two relationships is provided below:

BSS/SB Relationship

BSS provided many centralized services to SB. As one of its services, BSS maintained inventory for SB. Whether this inventory was used by SB for regulated operations or nonregulated operations was completely irrelevant to BSS. BSS charged SB for the cost of purchasing inventory, expenses related to handling the inventory, and a cost of capital. (For further details see section on BSS' billing methodology below.) The provision of inventory to SB was NOT an unprofitable business for BSS. This is true whether BSS was providing SB with CPE inventory or non-CPE related inventory.

SB/SB Customer Relationship

SB, in turn, used the inventory it purchased from BSS in both its regulated and nonregulated operations. If it was used for regulated customers, it was booked to regulated operations. If it was used for CPE customers, it was booked to nonregulated operations. Revenues from regulated customers were booked to regulated operations and revenues from CPE customers were booked to nonregulated operations on SB's books. Any losses from CPE were booked entirely to nonregulated operations on SB books. CPE losses remained in nonregulated operations on SB books and were NEVER "added back to regulated operations."

BSS' BILLING METHODOLOGY

As discussed above, BSS was, in essence, a cost center, which provided goods and services to its clients, primarily SB and SCB. For services and goods that it provided the telcos, BSS determined their costs on a fully distributed basis, added the allowable rate of return, and charged the telcos the resulting figure. For instance, if SB needed CPE for a customer, BSS determined the cost of the CPE and then added to that cost the expenses associated with handling the CPE, including a predetermined cost of capital. If BSS provided SB with a service, instead of CPE, it followed the same path. It determined the cost of the service, added any other expenses incurred, including a cost of capital, and billed SB. It was irrelevant whether CPE was involved or any other service, BSS determined the cost, added a cost of capital, and billed the result to SB.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 12
September 1, 1994
Page 3 of 5

COMPANY RESPONSE (Cont'd.):

The cost-of-capital methodology was specifically designed to ensure that cross-subsidization did NOT occur. Earnings requirements for BSS were determined based on the overall allowable rate of return. This earning requirement was assigned to pools of operating units with similar asset usage in proportion to the assets in the pool. A cost of capital loading was then calculated for each pool to achieve the overall allowable rate of return. By using this methodology, the cost of capital for each type of asset took into account different usage and turnover rates.

If it were CPE that was being billed to SB, SB would record the charge as an unregulated expense, and if it resold the CPE to a customer, would record the revenue from the sale as unregulated revenues. If it were a regulated service, SB paid for the service out of regulated funds. In either event, the charges to SB from BSS were based on the same overall rate of return. Any calculation by the auditors that purport to show that BSS earned a different return on its investment in CPE as opposed to the other services it provided, is simply incorrect. Such a conclusion is at odds with both the theory and the facts which underlie BSS's billings.

Obviously no subsidy occurred, because the price SB paid BSS for CPE and the revenues received from the end user were all treated as unregulated services. The ratepayers were not affected because every service and product were marked up to achieve its share of the earnings requirements.

CPE OPERATIONS

The audit report is incorrect in its allegation that any CPE losses or inventory write-downs impacted the regulated ratepayer. All CPE losses were booked entirely to nonregulated by Southern Bell. The Company's accounting for the CPE inventory write-downs was also appropriate and it ensured that the regulated ratepayer was not adversely impacted. Any CPE inventory write-downs were subsequently billed to Southern Bell and South Central Bell and booked as a revenue deduct to CPE nonregulated revenues (Account 5280). This accounting only impacted nonregulated operations.

BSS EQUITY

As stated above, earnings requirements for BSS were determined based on the overall allowable rate of return. The auditor's report is flawed in its attempt to assign equity to business segments. The Company could not and did not assign equity investment to its business segments.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 12
September 1, 1994
Page 4 of 5

COMPANY RESPONSE (Cont'd.):

With the reintegration of ASI, \$55.9 million of equity was infused into BSS. This equity consisted of approximately \$32.6 million of inventory and \$23.3 million of cash equivalents and other assets. The inventory was used to fulfill SB and SCB's needs, which were either regulated or nonregulated depending upon the ultimate usage. The inventory may have been used by SB to provide CPE to external customers or to provide equipment for telco internal needs. The \$23.3 million of cash equivalents and other assets were utilized by all BSS operations, consisting of providing services and products to the telcos. These assets reduced the need for additional funding from other sources.

The auditor's use of \$55.9 million as CPE equity is erroneous. As discussed above, the absolute maximum amount of assets deployed for CPE was the \$32.6 million in inventory. If the auditor had recognized this in his calculation, his return for CPE would have been significantly higher and his return for regulated would have been significantly lower. This was discussed with the auditors on numerous occasions. This further shows the erroneous nature of the auditor's assumptions and conclusions.

Furthermore, the audit report is incorrect in its allegation that "the Company increased the add-back to its regulated rate base merely by relieving BSS of its liability for advances from other affiliates." In 1989, BSS did receive equity infusions of \$20 million and \$30 million from SB and SCB. However these equity infusions were not related to CPE but were necessary to reduce the level of advances from the telephone companies. At times these advances reached a threshold where management deemed it appropriate to reduce them with equity infusions. These equity infusions (and all BSS equity) were utilized by all BSS operations, which consisted of providing general services and products to its clients. These assets reduced the need for additional funding from other sources to support BSS' normal operations. The needs for continuous funds was evidenced by prior and subsequent telco funding to BSS for ongoing operations.

HANDLING OF BSS INCOME AND INVESTMENT FOR RATEMAKING

As an additional protection for the ratepayer, all earnings by BSS were returned to SB and SCB in the form of dividends. For intrastate ratemaking purposes, the telephone companies included both their investment in and dividends from BSS in above-the-line accounts, thereby further ensuring

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 12
September 1, 1994
Page 5 of 5

COMPANY RESPONSE (Cont'd.):

that profits from BSS operations were returned to intrastate ratepayers. Therefore, intrastate ratepayers were not overcharged by BSS. Furthermore, as stated in the auditor's report the treatment of the investment in BSS and its net income were specifically considered in Southern Bell's Rule Nisi (Docket 3905-U) proceeding and this treatment was allowed. Specifically, a BSS dividend of \$3,530,021 and BSS investment of \$19,328,907 were used in the Rule Nisi rate setting. This resulted in an 18.3% rate of return and a reduction in revenue requirements for SB-Georgia.

The audit report is correct that the refund for BSS alleged overearnings in connection with the FCC audit was booked to interstate operations only. However, that accounting was entirely appropriate since any alleged over earnings were already in intrastate operations through the BSS dividend. In addition, it should be noted that Southern Bell and South Central Bell also voluntarily reduced their plant accounts by \$3.9 million. Approximately 75 percent of that reduction did get assigned to intrastate operations.

CONCLUSION

The auditors have misunderstood the role of BSS and its billing methodologies. BSS applied a cost of capital to all products and services and this methodology was specifically designed to ensure that cross-subsidization did not occur. Earnings requirements (not equity) were assigned to pools with similar asset usage. This prevented BSS from subsidizing CPE and over earning on regulated operations. Furthermore, the inclusion of the BSS dividend and investment in intrastate results was an added protection to the ratepayer.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 13
September 1, 1994
Page 1 of 1

FINDING/RECOMMENDATION:

The calculation and booking process used to record transfers of equipment between regulated companies should be mechanized to prevent errors.

COMPANY RESPONSE:

The report correctly concludes that Southern Bell is "...correctly following the rules governing the transfer of regulated assets from one jurisdiction to another..." and it states that "no errors were noted in the data reviewed..." The concern expressed is that the process of recording the transfers is not mechanized and it should be in order to prevent errors and expedite the journal processing. As stated in the report, SB is planning to mechanize this process. Current plans are for system testing in the fourth quarter of 1994 with implementation by second quarter 1995. This should alleviate any concerns raised by this finding.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 14
September 1, 1994
Page 1 of 2

FINDING/RECOMMENDATION:

Recent legislative and regulatory initiatives increase the urgency of eliminating subsidies found in this audit.

COMPANY RESPONSE:

SENATE BILL 566

The comments, observations and conclusions made by the auditors with respect to Senate Bill 566 (S.B. 566) are completely misleading and reflect a total lack of objectivity on the part of the outside consultants. Political commentary and speculation on the Company's or anyone's motives in the legislative process are far removed from the scope of this or any credible audit. This finding might be appropriate on the editorial pages of a newspaper but has no place in a formal audit.

First, Southern Bell did not propose S.B. 566. Southern Bell has no seat in either Chamber of the General Assembly. Instead, the bill was co-sponsored and introduced by four highly regarded, well-respected members of the State Senate. As stated in the preamble to the bill actually introduced, S.B. 566 was designed to recognize and prepare the State of Georgia for monumental changes taking place in the telecommunications industry. The bill sought to secure the benefits of these changes for the citizens of this state. Without a doubt, Southern Bell strongly supported the measure.

The auditors contend that the Company's primary motive for supporting such regulatory reform was to enhance its opportunity and incentive to cross-subsidize between regulated and deregulated services and to shift cost from competitive to non-competitive services. They further assert that under such legislation, the Company would have the "unrestricted ability" to set prices, without regard to cost for competitive services.

There were absolutely no provisions in S.B. 566 that would have permitted the Company to perpetrate such abuse. This legislation did not propose to deregulate any services. The Commission was given the authority to deregulate services. It has that authority today. See O.C.G.A. 46-2-23(b)(1). Tariff filing for regulated services would have continued.

Note: Contrary to the Report, the bill was not withdrawn. It was not voted out of committee. However, both Chambers passed resolutions establishing study committees to examine issues related to telecommunications and local competition.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 14
September 1, 1994
Page 2 of 2

COMPANY RESPONSE (Cont'd.):

Price levels for all non-basic services would have continued to exceed long run incremental costs. The Commission would have maintained full regulatory oversight over all regulated services to assure that consumer and competitive safeguards are adhered to.

In fact, under this legislation the prices for basic services would have been capped at existing levels for three years, after which they could only have been raised, if at all, by the rate of inflation. In other words, the opportunity to shift costs to the "captive customers" would have been virtually eliminated, rather than enhanced. It is misleading to refer to these as indexed price increases. To suggest that costs, and thus prices, can be shifted from competitive to non-competitive, optional services is purely speculative and completely unrealistic in either the current environment or in the environment envisioned under S.B. 566. Eventually, competition would drive the price for all services. In their analysis, the auditors do not even mention the fact that Southern Bell, or any other LEC, would have to, in effect, surrender its local franchise in order to obtain the regulatory flexibility which they describe in subjective and misleading terms.

The auditors' assertions, on the surface, would indicate that they have a fundamental misunderstanding about S.B. 566 and also do not fully understand the current regulatory oversight process utilized by the Commission in tariff filings. However, a considerable amount of time and effort was expended in order to educate them in that regard. Regardless, it is not an auditor's role to argue policy. An auditor tests whether policy, as reflected in current rules and procedures, is being followed. Political posturing and prognostication have no place in "audits."

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 15
September 1, 1994
Page 1 of 1

FINDING/RECOMMENDATION:

The Company's regulated vs. nonregulated cost allocation process should be subjected to continued and increased audit scrutiny.

COMPANY RESPONSE:

As stated by the auditors in the report, these transactions had no adverse impact on Southern Bell's regulated activities in Georgia.

Public Telephone Voice Messaging Service (PTVM) was never offered to the public in Georgia. As stated in the auditor's report, the assignment of overhead costs to nonregulated PTVM operations by the Company's Cost Separation System (CSS) benefited the Georgia ratepayer.

The revenues associated with Customer Dialed Account Recording (CDAR) have been assigned to regulated. The revenues were assigned to regulated operations because the costs associated with modifying the Company's billing system (Customer Record Information System - CRIS) were significant when compared to the product's small revenues, particularly since CDAR service represents an older declining technology that will eventually be eliminated. However as stated in the report, the expenses were properly assigned to nonregulated operations, and ratepayers again benefited from this transaction.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 16
September 1, 1994
Page 1 of 3

FINDING/RECOMMENDATION:

The auditors recommend the use of positive time reporting for BellSouth's and Southern Bell's legal departments.

COMPANY RESPONSE:

This finding is incorrect in its assertion that current time reporting procedures and controls are inadequate, particularly in the legal area. The recommended use of positive time reporting for legal would be a costly, work intensive effort. The Company and the entire industry are currently attempting to make time reporting procedures more cost effective (e.g., statistical sampling time reporting for certain network employees). The recommendation for additional positive time reporting would be moving in the opposite direction.

The Company's response is provided below in the following areas; BST Time Reporting and cost allocation, Job Function Code audits, and the BSC allocation of legal costs.

BST TIME REPORTING AND COST ALLOCATION

The time of each employee is assigned to a Job Function Code (JFC) as determined by an analysis of that employee's work. Once the assignment is made, it is updated periodically or when the employee's work content changes. The employee uses "exception time reporting" when the employee does something totally outside the scope of his or her normal duties, i.e., does work that would not normally fall within one of the JFCs used by that employee.

The assignment of the employee's time to the various JFCs could be audited by anyone who chooses to do so. In conducting such an audit, the auditor could determine whether the employee's time was properly apportioned. Daily time records are not necessary to achieve this same result.

During 1988-1991, departmental JFC representatives were responsible for training employees in the use of JFCs and for coordinating appropriate JFC changes. In October 1993, the responsibility for performing accounting data reviews was centralized in the Comptroller's Time Reporting Administration and Compliance group.

This group now performs semiannual JFC reviews utilizing statistical sampling. Adjustments and changes are made if appropriate. Also, effective in the fourth quarter of 1993, a monthly report of non-monetary payroll changes (e.g., employee moves, changes, etc.) is being generated and sent

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 16
September 1, 1994
Page 2 of 3

COMPANY RESPONSE (Cont'd.):

to segment accounting coordinators. These segment accounting coordinators are responsible for reviewing their employees' JFCs and initiating any changes that may need to be made. This provides an effective control to ensure that JFCs are updated when employees' responsibilities change.

Furthermore, the auditor's recommendation "that the cost pools to which Legal Department time is assignable include nonregulated, interstate and intrastate"... is not appropriate. First, the Company's Cost Allocation Manual (CAM) includes a direct regulated/nonregulated cost pool in Account 6725 (legal expense) and that cost pool is used. Secondly, interstate and intrastate allocation is handled via the Part 36 Separations rules and not by CAM cost pools.

The above described procedures and controls regarding Job Function Codes and exception time reporting are more than adequate to ensure that BST's legal costs are appropriately allocated to regulated and nonregulated activities. Additional burdensome positive time reporting by BST legal is not necessary since their efforts are generally associated with activities within BST and they do not provide legal services for nonregulated subsidiaries.

JOB FUNCTION CODE AUDIT

The statement that there were no audits of the Legal Department is misleading. As noted in the auditor's report, there was a JFC audit in 1991 and members of the Legal Department were included as part of the universe that was sampled. All SB employees were included in the audit sample, and the sample was selected so that it would be statistically valid at the 95% confidence level for the universe of all employees.

BSC ALLOCATION OF LEGAL COSTS

The auditors state that 88 percent of a certain BSC attorney's (R. Frost Branon) time was assigned to regulated. Actually only about 63 percent of his time was charged to intrastate regulated operations. Approximately 88 percent of Branon's time was billed to telephone operations. Of this amount billed to the telcos, approximately 95 percent would have been assigned to regulated operations within the telco, and approximately 75 percent of that amount would have been charged to intrastate operations.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 16
September 1, 1994
Page 3 of 3

COMPANY RESPONSE (Cont'd):

Furthermore, in request JVC-49, the auditors asked for a list of all of BellSouth's legal filings in 1991, which was provided together with the name of the attorney that worked on the filing during that period. The auditors did not sufficiently review the underlying work to determine whether it involved regulated or unregulated activities. In addition, the auditors did not ask whether Mr. Branon worked on other matters during the relevant period. Consequently, the auditors did not ask for sufficient information to reach their conclusion.

In reviewing the limited historical information requested, the auditors failed to consider or inquire concerning changes in the time reporting procedures which have taken place since 1991. Upon consolidation of the BellSouth and BellSouth Enterprises Headquarters organizations, the combined Legal Department implemented procedures for regular periodic time and expense reporting. These procedures were implemented because of the increased BellSouth Legal Department work for unregulated entities which occurred following combination of the two organizations. Prior to that time, most legal work for BellSouth Enterprises companies was performed by the BSE Legal Department, rather than at BSC. Accordingly, this finding is unnecessary and without merit as to both its factual basis and conclusions.¹

The auditors could have sufficiently explored the allocation of Mr. Branon's time to determine whether the Company had properly allocated it. They did not, and as a result, this finding is without support.

¹As explained in a previous section, these procedures are not required for the BST legal department due to the nature of their work.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 17
September 1, 1994
Page 1 of 2

FINDING/RECOMMENDATION:

Chaining calculations relating to affiliated transactions should recognize operations, such as BAPCO, which are treated as regulated at the intrastate level.

COMPANY RESPONSE:

This finding includes several inaccurate statements and conclusions which are explained below.

BSE did not incur an excessive lease payment. The difference in the two leases is explained by various benefits received by BSE such as private lobby area, first choice of floor space, floor location, etc. which are not quantifiable for purposes of the financial comparison performed. Although these differences are important, BSE nevertheless adjusted the potential chained overage each year to avoid even any possibility of regulatory noncompliance.

Further, this finding, even as asserted, no longer has any basis because BSE ceased leasing space in the 1100 building in 1994.

This finding is also in error because it draws incorrect distinctions concerning BAPCO. Neither BAPCO nor its earnings are deemed regulated by the FCC. Further, BAPCO is in an intensely competitive business and "treating it as regulated" for this purpose is beyond the Commission's jurisdiction. The C&L audit and potential chaining calculation were thus validly performed.

In addition, BSE's management fee to BAPCO was calculated as a percentage of BAPCO's expenses so BSE's incurred lease costs did not affect BSE charges to BAPCO or reduce BAPCO's net income in any way.

Further, in various analyses related to management fees, BSE has demonstrated that overall costs of BSE incurred on behalf of subsidiaries greatly exceeded charges to its subsidiaries. BAPCO is included in each of these analyses. Even if "excess" lease costs alleged by the audit team were deducted from fully distributed costs or overhead rates in these analyses, allocations computed in compliance with the JCO would still greatly exceed actual charges billed to all subsidiaries, particularly BAPCO. The Georgia audit team has had the opportunity to review these analyses in the C&L workpapers and yet failed to recognize or acknowledge this fact.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 17
September 1, 1994
Page 2 of 2

COMPANY RESPONSE (Cont'd.):

The audit team's recommendation that the Commission have access to the books and records of the unregulated affiliates is wholly without merit; these documents are not in the possession, custody or control of the regulated entity. The C&L workpapers contain sufficient information for a full and complete audit and support the responses above.

Based on the above, the audit team's recommendation that the Commission impose strict monitoring of BSC's affiliate leases demonstrates an astonishing lack of understanding of the stringent rules with which BSC is already in compliance. The FCC has already imposed "strict rules governing...allocations of expenses" in order to avoid cross-subsidization; therefore, the recommendation for more restriction is inappropriate and without basis. The requirements proposed would be both burdensome and unnecessary.

Southern Bell Telephone & Telegraph Co.
Georgia PSC Staff Audit
Response to Findings
Item No. 18
September 1, 1994
Page 1 of 3

FINDING/RECOMMENDATION:

Sunlink's Corporate cost allocation process provides an opportunity for the regulated telephone operations to subsidize BellSouth's nonregulated commercial ventures. If Southern Bell is unwilling to calculate the portion of Sunlink's lease price increases which flow into regulation, the total amount of the leases should be disallowed.

COMPANY RESPONSE:

This finding is incorrect and reflects a lack of understanding of the information provided and reviewed and the allocation procedures therein described. This finding includes many incorrect statements, the most significant of which are corrected in this response.

- The finding ignores obviously material facts in stating "During the 1987-88 time period, the auditors noted that there were significant increases in the lease prices per square foot at the Birmingham and Jacksonville locations."

As was documented to the auditors, these rate increases were not the result of any changes in accounting techniques or mechanization of the cost allocation system. While it is true that mechanization of the cost allocation system represented a change for Sunlink in 1991, it neither caused a substantial increase in cost allocations used for comparison purposes only nor did it effect lease rate charges which were established through contract negotiations several years prior to 1991.

Contract negotiations and lease agreements between Sunlink and BST management are typical of arms-length transactions in the industry whereby rates are established based on the real estate market at the time of negotiations. Amenities, concessions, condition, and value of the property are all considered in these transactions and factored into the negotiated rate. New leases for the Jacksonville and Birmingham warehouses were negotiated in 1987 and 1988 respectively. It is reasonable that rates for the entire space leased changed from previous leases which were at or near their expiration for several reasons. First, real estate market rates would have obviously changed between 1984 and 1987, even absent the inflationary real estate market. Also, additional space, improvements, and amenities, which increased the value of the space overall, were added to each of the warehouses based on the requirements of BST as follows: